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SUBJECT: RETAIL BANKING SEES MODEST INCREASE IN RISK PROFILE

Reftel A: Mumbai 436; Reftel B: Mumbai 409

¶1. (SBU) Summary: Retail banking has grown quickly over the past few years and has expanded into higher risk areas like credit cards and unsecured personal loans. Retail banking assets nevertheless remain heavily concentrated in safer home loans, which have high collateral, often have a close tie to borrower income, and can rely on the borrower's extended family to cohabitate and hence contribute to payments. The result is that, even with rapid growth in this relatively new area of lending, prudential norms and cautionary banking practices have contained bad loans to levels commensurate with expectations given the moderation in economic growth. End summary.

Retail Banking Overview

¶2. (U) Retail banking comprises those banking services that interact directly with consumers rather than other banks or firms. Reserve Bank of India (RBI) data shows very high growth rates in the retail sector - 41% in FY2005-06 and 20.9% in 2006-07. The share of retail banking in total banking activity has risen from 9.4% in 1990 to 22% in 2005 and 25% in 2007.

¶3. (U) RBI data show the following breakdown of the retail banking sector for FY2006-07:

	Share of Retail	Growth
Housing loans	46.0	25.4
Consumer Durables	1.5	63.3
Credit Cards	3.8	47.3
Auto Loans	16.9	34.5
Other Personal Loans	31.8	31.1

Home loans

¶4. (SBU) Housing is the largest portion of the retail sector and benefits from substantial government support. Pullar Rao, Banking Supervision Manager at the RBI in New Delhi, told Econoffs that loans up to Rs 2 million ($47,000) benefit from a lower risk weighting at 75 percent, whereas housing loans above Rs 2 million must be risk weighted at 150%. [Note: The higher the risk weight of a bank's assets, the more the bank must hold in reserves. End note.] Moreover, home loans below Rs 2 million fall into the

"priority sector" in which banks are required to direct at least 40 percent of their loans. (Other areas of the priority sector include agriculture and small-scale industry.)

¶5. (SBU) Rao opined that India's housing sector is less susceptible to the kinds of problems that have befallen the US housing market because housing loans in India are made on the basis of the house's listed value, not its market value. While this may reduce the usefulness of a mortgage when housing prices are high, it does protect the banking system from large swings in housing prices. Secondly, bank assets cannot be individually sold off for securitization. Thus for the most part, credit risk stays with the issuing bank. Various private sector experts agreed that housing is the least vulnerable part of retail banking. Most Indians live in the home they have a loan on, and the home is generally used by an extended family, meaning the family will fight very hard to stay in the home and do whatever it can to pay the monthly bill.

¶6. (SBU) Tarun Bhatia, head of financial sector ratings for CRISIL - an Indian research and ratings firm owned by Standard & Poor's - expects mortgage asset quality to deteriorate modestly over the next three years, with delinquency levels rising to about 2.5-2.7 percent from 2.2 percent in March 2007. Bhatia said a situation like the sub-prime crisis in the United States is unlikely to occur in India because banks lend only for mortgages on first homes and the lending is based primarily on the income of the borrower, not the value of the collateral.

Credit cards

¶7. (SBU) Credit cards are one of the fastest growing segments of retail banking and also one of the riskiest. Banks have been aggressively selling credit cards and, with rising interest rates and the poor financial education of some borrowers, banking officials and regulators acknowledged to Econoffs that the segment is worrisome. In fact, RBI officials in Delhi complained of the ineffectiveness of India's do-not-call telephone registry to illustrate the aggressive tactics of credit card salespeople. (See Reftel A.)

¶8. (U) CRISIL's analysis suggests that credit card receivables are the most risky asset in retail banking. That said, credit cards still represent a small portion of total banking assets, making them unlikely to be a danger to the overall banking system. Moreover, according to Bhatia, credit card yields at 32-40% largely compensate for the deterioratinn of credit card receivables as an asset class. Bhatia noted that competition for business between credit card issuers has been fierce because credit cards are used as a loss leader in the banking industry. Banks hope that by offering attractive credit cards, holders will be more likely to make use of other, more lucrative credit products from the issuing bank.

Personal Loans

¶9. (SBU) Personal loans are a catch-all category comprised of a mix of secured loans, with collateral backing the loan, and unsecured loans, such as for weddings - a major category of retail banking business here - and education. The RBI does not collect data on the proportion of personal loans which are unsecured. Rajnish Datta, president of small business banking at Yes Bank, told Econoffs that the personal loan segment was doing poorly, an estimation shared by CRISIL's Bhatia for the industry as a whole. Datta said that because of its poor performance, Yes Bank was moving away from personal loans.

Assessing Credit Risk

¶10. (SBU) One potential concern in retail banking is the lack of sophistication of the industry's sole consumer credit bureau - CIBIL - and conflict between the RBI and the Finance Ministry over rules to allow new foreign entrants into the market (Reftel B). Aside

from credit bureaus, banks most commonly use income tax receipts to verify income. Most Indians do not report their income, however, and those that do often underreport their true income in order to lessen their tax burden. Datta, of Yes Bank, told Econoffs that he thought income is underreported and that this poses a problem for Yes Bank in trying to issue loans. He said that Yes Bank sends out agents to peoples' homes to verify information if the loan amount was over Rs. 500,000 (about $12,000).

¶11. (SBU) The result is that individuals that do not have proof of income are generally only able to obtain secured loans, if that. Though the government does not collect data in this area, RBI and bank officials alike thought most loans probably go to salaried individuals. V.M. Sharma, of Punjab National Bank (PNB), explained that educational loans, because of their official priority sector designation, are often granted purely on the basis of a letter of admission and the quality of the school's website.

Comment

¶12. (SBU) The rapid growth of banking assets in personal consumer loans is a cause for concern. However, while non-performing loans (NPLs)(i.e., bad loans) are on the rise, this primarily represents disproportionate expansion of lending in risky categories like credit cards and unsecured personal loans, rather than an unexpectedly sharp increase in NPLs within individual loan categories. Most importantly, the largest category, home loans, has not seen deterioration. Further, higher rates charged in riskier categories presumably compensate banks for higher levels of risk. The rise in NPLs is not surprising given the cooling Indian economy and the prevailing view is that the rise in NPLs is proportionate to the slowing economy and tighter monetary policy.

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